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# Private Foundations: New Program-Related Investments Guidance

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Recently, the directors and managers of private foundations read some good news in the Federal Register. On April 25, 2016, The U.S. Treasury Department issued its long-awaited, final regulations on program-related investments, commonly known as "PRIs."

What are program-related investments?

They are an important, useful, and socially beneficial exception to the general rules that foundations must follow in managing and investing their endowments.

Private foundations, of course, are a popular vehicle for philanthropists who want to keep "hands-on" control of their charitable dollars. There are tradeoffs, though: in exchange for this benefit and others including generous tax deductions, foundations and their managers are subject to heavy restrictions on finances and operations. The penalty for violating these rules can be hefty excess taxes on the foundation itself as well as managers who knowingly participate in the plan.

## *Jeopardizing Investments Excise Tax*

One such rule prohibits foundations from investing in any "jeopardizing investment"; that is, investing "any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes." This restriction and the excise tax imposed for violating it, are described in section 4944(a) of the Internal Revenue Code.

In an IRS publication, the agency explains that jeopardizing investments are ones that "...show a lack of the reasonable business care and prudence in providing for the long- and short-term financial needs of the foundation for it to carry out its exempt function."

## *Safe Harbor for Program-Related Investments*

This is how PRIs – which are the *opposite* of the usual investing-for-maximum-profit model – fit into the overall regulatory scheme. If a foundation makes a qualifying program related investment, there is no "jeopardizing investment" excise tax.

PRIs are made primarily to achieve one or more "exempt" purposes, instead of to generate as much money as possible for the foundation. Section 4944, subs. (c) is the statutory authority for this critical safety net for foundations that want to use and manage their funds more broadly than just to make grants:

> EXCEPTION FOR PROGRAM-RELATED INVESTMENTS. *For purposes of this section, investments, the primary purpose of which is to accomplish one or more of the purposes described in section 170(c)(2)(B), and no significant purpose of which is the production of income or the appreciation of property, shall not be considered as investments which jeopardize the carrying out of exempt purposes.*

Section 4944(c) is brief and to the point. Of course – as with so many other tax *and* non-tax statutes – the devil is in the details. Fuzzy terms like "primary purpose" and "significant purpose" don't help much.

## *New Regulations Give Needed Clarification*

To remedy some of the vagueness of the statute, and to help foundations understand what may pass muster as a program-related investment, the Treasury Department issued regulations in 1972. Included were nine examples describing investments that qualify as PRIs. There is also one example of an investment that fails to meet the PRI statutory definition. These examples, in place for decades, "focus on domestic situations principally involving economically disadvantaged individuals and deteriorated urban areas."

In 2012, federal officials, with encouragement from the Obama Administration, proposed amendments to update and broaden the PRI regulations to include examples of qualifying PRIs that are broader in scope than the earlier ones.

These changes were made to reflect emerging views and practices in the philanthropic community that foundations could be used more effectively to help communities and societies as a whole. Also, "in recent years," the philanthropy community as well as "impact investing coalitions" requested "guidance how they can make investments for both charitable purposes and financial returns while staying within the tax rules for foundation investments."

Following the publication in 2012 of the proposed amendments, there were few objections submitted during the public-comment period.

The final regulations (Treas. Reg. sec. 53.4944-3(b), as amended) just published are substantially similar to the 2012 proposed regulations; they were tweaked a bit, though, in response to the public suggestions.

The 2016 amendments include an additional slew of examples that include – significantly – a broader swath of investment activities that qualify as program-related investments.

> *The purpose of this regulatory project was to update the long-standing examples of investments that qualify as program-related investments, most of which focused on supporting domestic community redevelopment projects through below-market loans. The new examples reflect the diverse ways that foundations currently employ program-related investments to further their charitable missions. The final regulations also complement the increasing focus of the foundation community (and other institutional investors) on how to use their entire investment portfolios to further their mission. * * * The proposed (and now final) regulations add nine new examples to the existing nine examples illustrating investments that qualify as program-related investment.*

In the announcement of the publication of the final regulations in the April 25, 2016, edition of the Federal Register, officials explained the new approach:

> *The proposed examples demonstrated that PRIs may accomplish a variety of exempt purposes (and are not limited to situations involving economically disadvantaged individuals and deteriorated urban areas), may fund activities in one or more foreign countries, and may earn a high potential rate of return. The proposed examples also illustrated that a PRI may take the form of an equity position in conjunction with making a loan, and that a private foundation's provision of credit enhancements can qualify as a PRI. In addition, the examples illustrated that loans and capital may be provided to individuals or entities that are not within a charitable class themselves, if the recipients are the instruments through which the private foundation accomplishes its exempt activities.*

In a blog post, the Director of the White House Office of Social Innovation and Civic Participation, David Wilkinson, comments on these new regulations:

> *Many foundations have had misperceptions of the rules governing PRIs and many believed that expensive processes, such as specific IRS approvals or legal opinions, were necessary to safely use this tool.*

"These additional examples," he adds –

> *illustrate the wide range of investments that might qualify as PRIs, including those accomplishing a variety of charitable purposes and utilizing a variety of financial arrangements….[This guidance]…reassures foundations that a wide range of investments can qualify as PRIs and reduces the perceived need for legal counsel or IRS rulings in many cases.*

Wilkinson emphasized the "clear message" sent by the Obama Administration through these regulations encouraging "creative thinking, willing partners, and a variety of financial resources" to build "…ladders of opportunity for all Americans."

> *When we think about a private foundation, an institution operated exclusively to further its charitable purpose, we often think about philanthropy's ability to make grants, convene, and build partnerships, but don't always consider its investment capabilities. Traditionally, a foundation has viewed its financial resources as two distinct pots of capital: funds set aside for grants that further charitable purposes, but are not repaid; and funds dedicated to investments, which provide a financial return and maintain the value of the endowment as an ongoing source for future philanthropic activity.*

## *Conclusion*

Foundations today are "realizing the benefits of tools for funding charitable projects that do not neatly fall into one category or the other"; that is, investments or grants. These newly issued regulations should encourage foundations and their directors and managers to adopt innovative practices without fear of incurring crippling "jeopardizing investment" excise taxes.